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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Financing East European Imports from the Industrial West

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1972

INTELLIGENCE MEMORANDUM

FINANCING EAST EUROPEAN IMPORTS FROM THE INDUSTRIAL WEST

Introduction

1. The boom in East-West trade has brought a rapid development of sources and methods of financing East European[1] hard currency imports from the industrial West. This memorandum identifies and describes the various kinds of credit and the credit institutions involved in the trade. Although Eastern Europe has been engaged longer and more fully in credit dealings with the West, the analysis, except where noted, applies to the USSR as well. The special case of Yugoslavia, which uses similar credit facilities, is not considered.

Summary and Conclusions

2. Eastern Europe's trade with the industrial West has increased rapidly for more than a decade, and its hard currency debt has grown much faster. Outstanding medium-term and long-term debt, almost all in hard currency, rose from US $600 million in 1960 to about $3.3 billion in 1970, and to more than $4 billion in 1972. The major East European debtors are Romania, Poland, and East Germany.[2] The rise in indebtedness results mainly from imports on credit of machinery and equipment, although periodic purchases on medium-term credit of food and industrial materials have added to the debt burden. Soviet indebtedness, stemming largely from purchases of plant and equipment on credit, has grown rapidly since the mid-1960s, when gold ceased to be the principal Soviet means of financing hard currency deficits. At the end of 1971, the USSR owed $2 billion on medium-term and long-term credits.

1. Bulgaria, Czechoslovakia, Hungary, East Germany, Poland, and Romania.
2. Including the East German swing debt to West Germany.

Note: This memorandum was prepared by the Office of Economic Research.

3. Eastern Europe's principal creditors in the industrial West are the Soviet-owned banks, large West European commercial banks, and official Western rediscount institutions. The Soviet banks are Eastern Europe's most versatile creditors, performing a broad range of services (for a fee) for their Eastern correspondents, including arranging consortium loans, handling foreign exchange transactions, and providing non-guaranteed credit. Western commercial banks absorb much of the westward flow of Soviet and East European notes and bills, which are either retained in bank portfolios or rediscounted through various outlets, including the official Western rediscount institutions. Western "specialist" banks, centered primarily in Vienna, Zurich, and Basel, together with the Soviet-owned banks, provide most of the nonguaranteed suppliers' credits available to Eastern Europe.

4. At present, at least one-half of Eastern Europe's and nearly all the USSR's medium-term and long-term debt is covered by export insurance offered by agencies of Western governments and by the Soviet-owned insurance company Garant in Vienna. Western countries, meeting through the Berne Union, have helped to stabilize the competition among exporters over credit terms granted to Eastern Europe, and the terms currently offered by various Western systems are quite similar.

5. Financing of exports to Eastern Europe and the USSR takes the form of suppliers', buyers', and financial credits. Suppliers' credits are offered in the form of letter of credit facilities and "indirect non-recourse" credits. Buyers' and financial credits take the form of clean credits, indirect financing, and "tied" credit lines.[3] In addition, Western governments and the Soviet Union have loaned hard currency to Eastern Europe for purposes of refinancing, export promotion, and meeting emergency requirements for food and other goods.

6. Except for government-backed credits covering exports of agricultural products, the US financial community has extended only small amounts of credit to cover exports to Eastern Europe. Until October 1972, this was also true for exports to the USSR, but US banks are now mobilizing substantial sums for long-term credits to the USSR. US banks do finance a small amount of the trade on nonguaranteed medium-term credit. They would be willing to finance some expansion of capital equipment exports to Eastern Europe without Export-Import Bank guarantees, but much larger credits could be financed if insured under the Export-Import Bank program. Romania, Poland, and the USSR are currently the only CEMA countries eligible for Export-Import Bank guarantees.

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3. These and other terms used in financing international trade are explained in the Appendix.

7. Eastern Europe's hard currency debt is expected to continue to rise in the years ahead. Western credits will be needed to cover planned imports of machinery and equipment, as well as purchases of agricultural and other goods resulting from unanticipated shortages. The USSR will also increase its debt to help finance planned imports of capital goods and grain. The East European countries, however, are looking to joint ventures and cooperation arrangements to alleviate the growing burden of indebtedness and to offset the declining growth rate of traditional exports to the West – particularly agricultural and industrial raw materials – by providing a means of importing capital, managerial help, and licenses while minimizing hard currency outlays. The USSR will emphasize "self-liquidating" types of agreement – that is, importing Western capital and know-how on credit and repaying the credit in raw materials developed from the Western investment.

Discussion

The Roots of East European Indebtedness

8. In the 1960s, Eastern Europe's trade with the industrial West nearly tripled. Imports were consistently greater than exports and rose faster, and the growing trade deficits were not significantly reduced by increased earnings on invisibles. As a result, indebtedness to the industrial West grew to nearly six times the level in the late 1950s. In 1960, medium-term and long-term indebtedness in the West amounted to about $600 million; by 1970 it reached about $3.3 billion. Soviet trade with the industrial West more than doubled during the 1960s, and hard currency indebtedness rose from only $50 million at the end of 1959 to $1.7 billion at the end of 1970. The ratio of East European and Soviet indebtedness to exports (shown in the table) increased throughout the period.

9. Ratios of annual debt servicing on medium-term and long-term credits (repayments including interest) to exports are a more meaningful measure of debt burden. Rough approximations of debt servicing in 1971 are shown below for the USSR and the East European countries:

	Percent
USSR	20
Bulgaria	45
Czechoslovakia	20
East Germany	25
Hungary	20
Poland	20
Romania	35

East European and the USSR Exports and Medium-Term
and Long-Term Debt in the Industrial West

	1960			1970		
	Million US $		Debt as Percent of Exports	Million US $		Debt as Percent of Exports
	Exports	Debt[a]		Exports	Debt[a]	
Bulgaria	68	100	147	260	400[b]	154
Czechoslovakia	309	20	6	746	400	54
East Germany	420[c]	200[d]	48	904[c]	600[d]	66
Hungary	185	30	16	634	400[e]	63
Poland	374	250	67	962	650[e f]	68
Romania	146	20	14	550	900	164
Total	**1,502**	**620**	**41**	**4,056**	**3,350**	**83**
USSR	739	136	18	2,196	1,694	77

a. The Bulgarian 1960 debt figure is confirmed by documentary sources. The other debt figures, for Bulgaria as well as for Hungary, Poland, Romania, and the USSR, have been derived in various published CIA balance-of-payments studies. Those for Czechoslovakia are based on unpublished balance-of-payments estimates. The 1960 and 1970 estimates for East Germany are rough approximations based on trade balances and fragmentary data on invisibles earnings for the period 1950-60.

b. In providing debt relief to Bulgaria in 1969, the Soviet Union refinanced a portion of Bulgaria's debt through the Soviet banks in the West, reducing repayments pressures but not the level of overall indebtedness.

c. Including trade with West Germany.

d. Including the East German swing deficit with West Germany.

e. Rounded to the nearest $50 million.

f. Excluding amounts owed on PL-480 credits; some $400 million remained as of January 1972.

Romania and Bulgaria carry the highest debt servicing ratios. Romania's debt burden has been relieved somewhat by West German and French rescheduling and fairly rapid growth of exports to the West. Bulgaria, on the other hand, has had little success in boosting exports and has had to rely on Soviet assistance to avoid default. Czechoslovakia and East Germany show relatively high ratios in part because most of their indebtedness is medium term, and because the growth of exports has slowed down. The other countries face less severe repayments pressures, and all have managed rapid growth in exports to the West in recent years.

10. East European indebtedness has continued to rise in 1971-72 by several hundred million dollars. In addition, the dollar equivalent of the debt was raised by more than 10% because a good deal of it is in West German marks, French francs, and other currencies that appreciated in relation to the dollar in 1971. Present indebtedness in 1972 dollars is more than $4 billion.

11. Most of Eastern Europe's outstanding indebtedness can be traced to purchases of several billion dollars worth of Western machinery and equipment – chemical and petrochemical equipment, motor vehicle manufacturing facilities, metalworking and metallurgical equipment, and ships and marine equipment. Poland, Czechoslovakia, and Romania have been the leading importers of Western machinery, followed by Bulgaria and Hungary. East Germany has relied least on Western imports, although machinery imports have been growing very rapidly since the mid-1960s, especially from West Germany via interzonal trade.

12. Another major outlay contributing to the rise in indebtedness in the 1960s was for purchases of grain (wheat and corn), mainly in 1963-66 following poor grain harvests in both Eastern Europe and the USSR. In those years, Eastern Europe imported about $850 million worth of wheat and corn from industrial Western countries, much of it on medium-term credit from Western Europe and Canada, with the remainder paid for by the USSR. Eastern Europe has also bought industrial materials and even food on medium-term credit.

13. In 1960, early in the expansion of imports on medium-term and long-term credit, Poland and East Germany were the countries most heavily indebted. Bulgaria, however, was in the most difficult position; the ratio of its indebtedness to exports was already 1.5:1. Hungary had been in trouble in the mid-1950s, but after the 1956 revolt, the Soviet Union had paid off most of its debts (roughly $150 million) by selling gold through its Paris-based bank – the Banque Commerciale pour l'Europe du Nord (Eurobank). Romania and Czechoslovakia were only slightly involved in financial dealings with the West in 1960.

14. Since the early 1960s the greatest change has been in the position of Romania. Its hard currency debt has risen to 45 times the 1960 level, while trade with the industrial West has increased just over four times and imports only five times. Romanian medium-term and long-term indebtedness was still quite low in 1965 (at $215 million) but grew to $700 million by 1968 and to $1 billion by 1971. Because Romania would seek Soviet assistance only as a last resort, it is now in the weakest financial position of any of the East European countries, even though it does have gold stocks estimated at $125 million. A small hard currency loan from the People's

Republic of China in 1971 [redacted] and debt refinancing assistance from West Germany and France in 1969-71 barely enabled Romania to hold its own in the face of heavy debt servicing requirements. 25X1

15. Bulgaria has been in hard currency trouble off and on from having overestimated its ability to increase exports to Western Europe. Its ratio of debt to exports remains one of the highest in Eastern Europe, about 1.5:1. The Soviet Union bailed Bulgaria out of insolvency in the early 1960s and again in 1969 and still seems unable to control Bulgarian hard currency spending.

16. The debts of the other countries continue to run at less than the value of their exports. Poland, with the greatest volume of trade with the West, has the largest debt, if PL-480 credits are included. Polish policy on incurring hard currency indebtedness remained very conservative until the late 1960s, when purchases on credit began to rise sharply. Beginning in 1971, purchases on credit have been large, and the Gierek regime expects to rely heavily on credits to support economic expansion through the 1970s.

17. East Germany also was conservative in buying on credit from the West until the late 1960s, when indebtedness began to increase rapidly, almost all on medium term. The swing debt(4) owed to West Germany has increased, amounting to about $180 million at present. In addition, East Germany has drawn a sizable amount of credit for plant and equipment from West Germany guaranteed by a West German government agency. The regime has been able to get medium-term credit elsewhere in the West, especially from Swiss and American banks and from the Soviet-owned banks. Banking and commercial interests in Japan, France, and the United Kingdom also have begun to offer East Germany substantial credit facilities.

18. Czechoslovakia and Hungary have increased their indebtedness rapidly since the early 1960s, but from a very low level. Czechoslovakia has been fairly careful, although not very skillful, in respect to buying on credit. Medium-term credits bulk rather large in Czechoslovakia's indebtedness.

19. Hungary, with the most adept bankers and perhaps the most consistent and prudent economic policy, maintained by far the lowest ratio of debt to exports until 1969 -- the second year of the economic reform -- when the regime began drawing extensively on medium-term Eurodollar credits. By the end of 1970, Hungary's medium-term and long-term debt amounted to about $400 million. In 1971, Hungary ran a huge deficit with

4. The swing credits are interest free and apparently are indefinite in maturity.

the West, stemming from large imports of machinery combined with an unexpectedly sharp drop in earnings from exports of raw materials and semimanufactures. As a result, Hungary's debt to the West increased to at least $500 million, bringing tightened economic controls at home and drawing criticism from the Soviets. The Hungarian trade balance with the West is still negative, but the import surplus so far in 1972 is substantially less than that in 1971.

20. Through the mid-1960s, the USSR relied primarily on gold sales to finance its deficit. Thus, during 1960-65, Soviet gold sales averaged more than $370 million per year. Western credits – principally medium-term – played a relatively small role. Dwindling Soviet gold reserves and the availability of Western credit facilities with maturities in excess of five years resulted in increased Soviet use of Western long-term credits, which replaced gold sales as the chief element in financing the Soviet deficit with the West. The low level of its outstanding debt at the end of 1965 of less than $400 million reflected the generally shorter terms which had been available in the first half of the 1960s. In contrast, during 1966-71 the USSR drew down about $3.2 billion in Western medium-term and long-term credits with an average maturity of about eight years, and at the end of 1971 had an outstanding debt of more than $2 billion. Most of these drawings have been in support of imports of plants and equipment for the chemical, petrochemical, and automotive industries.

Eastern Europe's Creditors

21. The institutions that pioneered the financing of East-West trade were the two Soviet-owned banks in London and Paris, the Moscow Narodny Bank (MNB) and the Banque Commerciale pour l'Europe du Nord (Eurobank). Although the rapid expansion of other credit sources has reduced their importance, the Soviet banks remain Eastern Europe's largest single creditors in the West. While these banks also finance some Soviet imports, the USSR generally has been a net creditor to its own banks in the West.

22. Most of the financing of East European imports from the industrial West, however, is now done through large commercial banks in West Germany, France, the United Kingdom, Austria, Italy, and Switzerland. Probably fewer than 50 banks in these countries handle a large share of the financing of exports to Eastern Europe. Banks in London, Paris, Zurich, Rome, Milan, Vienna, and Frankfurt are the leaders in this business. The commercial banks, however, are often not the ultimate holders of East European paper (trade bills and promissory notes). Most countries have state-supported institutions that rediscount a portion of guaranteed paper to facilitate commercial bank liquidity and thus help promote exports. The

extent to which East European paper is spread around among banks, rediscount institutions, and commercial and private investment portfolios differs considerably from country to country. Nonguaranteed paper is handled – and held – by specialized banks with access to "high-risk" investment funds. The Soviet-owned banks discussed below deal in all types of East European paper.

Soviet-Owned Banks in the West

23. In addition to the MNB in London, its branches in Beirut and Singapore, and Eurobank, the USSR owns the Wozchod Handelsbank A.G. in Zurich and the Ost-West Handelsbank in Frankfurt. The East European countries as a whole owe at least $600 million in hard currency to these banks – primarily MNB and Eurobank. These banks have been more than just creditors; they have encouraged Western lending to Eastern Europe, especially in the years before Western confidence in Eastern banks was established. The Soviet banks were for a long time the only ones the East Europeans would trust to carry on foreign exchange transactions for them. They were the initial founders of – and remain the principal dealers in – the discount market for East European non-guaranteed notes and bills.

24. In addition, the Soviet banks' policies regarding East European payment of maturing obligations are in some cases more liberal than those of most other Western banks. In fact, it is practically impossible for an East European bank actually to be in default to a Soviet creditor-bank, given the Soviet government's desire to preserve the credit rating of its client states. As an example of extreme banking practices, short-term credits granted in 1959 and 1960 to Bulgaria by both MNB and Eurobank were refinanced, or "rolled over" again and again because of Bulgaria's inability to meet repayments, finally becoming long-term loans spanning seven years.

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They also finance trade at reasonable interest rates for East European countries at times when they have run up against ceilings set by Western governments – and commercial banks – on hard currency credits.

Western Commercial Banks

25. The most important Western-owned institutions involved in financing East European imports are the large West European commercial banks. These banks not only finance a considerable share of exports to Eastern Europe but also serve as primary buyers of paper that ultimately is rediscounted with government-operated rediscount organizations or sold through other outlets. Thus most of the East European short-term,

medium-term, and long-term paper at least passes through commercial banks, and their policies and practices are an important determinant of the amount and type of credit available to Eastern Europe.

26. The West European banks most involved in financing exports to Eastern Europe include the Deutsche Bank, Bank für Gemeinwirtschaft, and Dresdner Bank, all centered in Frankfurt; the Commerzbank of Dusseldorf; Lloyds Bank, Banker Trust Co., Barclays Bank, Midland Bank, and National Westminister, all of London; Credit Lyonnais, Credit Commerciale de France, and Société Générale, all of Paris; the Union Bank of Switzerland and Credit Suisse of Zurich; Swiss Bank Corporation of Basel; Banca Commerciale Italiana and Credito Italiano of Milan; Banca Nationale del Lavoro and Banca d'Italia, both of Rome; and Creditanstalt-Bankverein and Breisach and Schoeller Bank, both of Vienna. More than 20 other banks in Western Europe are quite active in East-West financing, but the above 21 banks have pretty much dominated the field.

Specialist Banks and Other Non-Recourse Creditors

27. In some East European countries, the need for credit has frequently exceeded that available under the various guarantee systems in Western Europe. As a consequence, sources of non-guaranteed suppliers' credit have developed as the demand by exporters for financing has increased. The biggest customers of goods financed in this makeshift non-recourse market have traditionally been Bulgaria and Romania, although exports to Poland, Czechoslovakia, and East Germany sometimes have been financed in the same way. The USSR has done very little borrowing in the non-recourse market.

28. The principal suppliers of non-recourse credit, are the Soviet banks -- MNB, Eurobank (on a smaller scale), and Wozchod Handelsbank A.G. Moreover, the high interest rates obtainable in the non-recourse market have spawned a growing number of finance companies or specialist banks, as they are called in Europe. These banks have been set up frequently by major commercial banks using high-risk funds, specifically to discount non-guaranteed medium-term and long-term promissory notes drawn on East European firms or trade organizations and guaranteed only by East European banks. The leading specialist banks are European Finance of Milan; Monaval Finance Ltd., Bank für Handel und Effekten, Noreco Finance, Ufitec International, and Finance Ltd., all of Zurich; and Sofigest Société Financiere of Geneva. In addition, several of the leading commercial banks, mainly in Zurich, Basel, and Vienna, have established separate departments that are actively engaged in non-recourse financing.

29. The formation of Noreco Finance, listed above as a specialist bank, offers one example of indirect commercial bank participation in the

non-recourse market. Noreco was established recently by the Dow Bank in Zurich together with the Lavoro Bank and three other European banks, with the purpose of sharing in the high profits earned in discounting and rediscounting non-guaranteed notes from Eastern Europe as well as certain less developed countries. In the short time it has been in existence, Noreco has become one of the largest dealers in East European paper in Zurich.

Western Guarantee and Credit Systems

30. The dramatic growth in exports of capital equipment to Eastern Europe on credit in the middle and late 1960s put considerable pressure on the West European financial community to provide low-cost medium-term and long-term credit amounting to several billion dollars. The most effective means of raising and securing such large sums of hard currency has been through official credit facilities and export-guarantee insurance. The Soviet insurance company Garant (Garant-Versicherungs AG) in Vienna, which writes a wide variety of insurance, took the lead in guaranteeing credits for Eastern Europe, a role parallel to that of the Soviet banks in arranging for credits. Garant has continued to play a considerable role in this field. In recent years it has been especially active in guaranteeing credits by Austrian and Swiss banks for West German exports to East Germany and Czechoslovakia, perhaps involving as much as $100 million a year in new credits. In 1968, Garant became very sticky about guaranteeing additional credits for Bulgaria and Romania (and Yugoslavia), countries that are not as good risks.

31. The greater part of the export guarantees in East-West trade are now being furnished by instrumentalities of Western governments, which normally are limited to guaranteeing exports of domestic origin. All of Eastern Europe's principal Western trading partners have such facilities for insuring – and for financing – exports, and most such facilities have been made available for exports to Eastern Europe. Commercial bank financing of exports of machinery and other manufactures frequently will require the issuance by an export credit insurance institution of a policy providing protection against commercial and non-commercial (political, monetary, and catastrophe) risks. An insurance policy is issued in favor of the exporter and assigned by him to the institution that finances the credit, to serve as collateral for the credit. Presently, at least one-half of Eastern Europe's and nearly all of the USSR's outstanding drawings on medium-term and long-term credit are covered by insurance.

32. In the early 1960s, Western competition for East European equipment orders began to shift toward credit terms and away from product specification, price, and service. West European countries made great efforts to compete with their neighbors by offering longer and longer credit terms

and/or lower interest rates, and the East European countries had a big hand in promoting this competition by playing various countries against one another to gain more favorable terms.

33. Quickly recognizing that such competition was not desirable, representatives of Western governments used regular meetings of the Berne Union to discuss export credit terms and to try to agree on voluntary limits, to be enforced through the government-controlled credit insurance organizations. Until the early 1960s, none of the members of the Berne Union insured credits with repayments running more than five years. Gradually, however, the competition for sales to Eastern Europe stretched the term, to an average of seven to eight years for large purchases and as long as 10 years or more for special cases. The generally accepted credit periods applicable to specific types of equipment or to a specific value of a contract have likewise been extended.

34. Competition among governments has streamlined the operation of the financing and insurance schemes throughout Western Europe, minimizing costs of premiums and interest rates, increasing the speed with which tentative and final approvals of requests for insurance or financing are given, and reducing the downpayment required from the purchaser at time of delivery as well as the amount of uninsured credit that must be financed outside the export credit system. Moreover, the terms of guaranteed credit offered to East European importers largely have been unified among principal creditor countries. All systems offer medium-term and long-term guaranteed credit at interest rates ranging from about 6% upward to 9% and covering between 80% and 90% of the contract price. Most systems provide for official or quasi-official refinancing of guaranteed paper, and all of the systems are large and deep enough to support credit financing to the East European countries well beyond the limits established for those countries.

35. Although terms are similar, institutions vary. In the United Kingdom, for example, the financing of credits covering exports of capital goods and related categories to Eastern Europe is carried out as part of regular banking business, mainly by the London clearing banks and some of the merchant banks. The Export Credits Guarantee Department of the Board of Trade provides export credit insurance. Interest rates on credits are currently running at a rate of 6%. The Bank of England has established partial refinancing facilities to cover guaranteed credits of two years or more.

36. In West Germany, the two organizations that normally finance export credits covering capital goods and related manufactures – the Ausfuhrkredit-Gesellschaft MbH and the Kreditanstalt für Wiederaufbau – are only barely involved in financing exports to Eastern Europe. Most credit

financing of this type is through the West German commercial banks, such as the Deutsche Bank AG, centered in Frankfurt. A fairly large portion of the credits is insured by the Hermes-Kreditversicherungs AG, the official export insurance organization.(5) Interest rates on new credits at the end of 1971 were averaging about 8% to 8.5%, although there are some exceptions (apparently reflecting interest rate subsidies) in the 6% to 7% range.

37. French exporters can extend suppliers' credits to East European importers through the French deposit and investment banks. Buyers' credits with a minimum maturity of eight years and involving minimum sums of 25 million francs are also financed through these two types of banks in cooperation with the Banque Francaise du Commerce Exterieur (BFCE). Medium-term (defined as two to five years in France) and long-term suppliers' credits are refinanced by the Credit National, which in turn rediscounts them with the Banque de France. For buyers' credits, the deposit and investment banks rediscount with the Banque de France the portion whose maturities do not exceed five years. The portion over five years is granted by the BFCE, which keeps such paper in its portfolio.

38. French credit institutions also grant financial credits to East European importers to cover down payments and ancillary costs under French contracts. French export insurance is provided by the Compagnie Francaise d'Assurance pour le Commerce Exterieur (COFACE). Interest rates in late 1971 were running about 6.1% to 6.8% on French-guaranteed credit.

39. West German export insurance premiums are quite modest and do not vary according to the credit rating of the importer or exporter. This gives German exporters some advantage over French and British exporters, who pay higher premiums and at differentiated rates. However, the total cost of credit has, for a number of years, been considerably higher in West Germany than in the United Kingdom or France, or in most other industrial Western countries for that matter. Furthermore, a much larger share of French and British capital goods exports to Eastern Europe has been financed through official financing agencies than has been the case in West Germany.(6) In all three countries, a large portion of credits covering machinery and equipment sales to Eastern Europe has been insured against political and commercial risks.

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5. In addition, West Germany in 1967 set up a special institution for financing plant and equipment sales to East Germany, called Gesellschaft zur Finanzierung von Industrieanlagen MbH (GEFI), because East Germany, not being a "foreign country" was ineligible for Hermes export insurance.

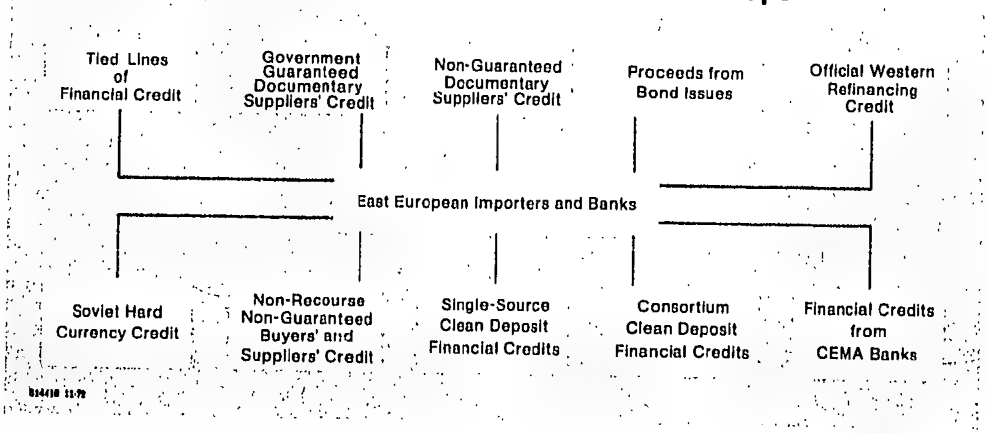
6. A considerable part of West German exports to Eastern Europe has been financed by Austrian and Swiss banks, apparently insured in part by Garant.

Types of Credit

40. Export credits take two basic forms – suppliers' credits and buyers' credits. Suppliers' credits are granted by suppliers, usually through commercial banks, to foreign buyers on a short-term basis (credits of one year or less from delivery), a medium-term basis (credits of one year to five years), or a long-term basis (credits of between five and 10 years from delivery). Buyers' credits are granted directly by banks or other credit institutions to foreign buyers, enabling them to pay cash to suppliers for imports. Credits of a third type called "financial credits" are granted directly to East European banks as general-purpose loans.

41. As shown in Figure 1, credits granted to East European importers from Western sources are a mixture of short-term, medium-term, and long-term suppliers', buyers', and financial credits. The repayment period is determined largely by the category of goods involved, although the credits covering sales to Eastern Europe sometimes run longer than the terms specified in the Berne Union understanding. Sales of consumer goods and raw materials generally are financed over one year or less. Durable consumer goods and industrial inputs (for example, chemicals) are financed over two years or less; light capital goods such as agricultural machinery, large commercial motor vehicles, lathes, and generators over three to four years; and heavy capital goods over five years or longer. Sales of agricultural products normally are financed over less than 18 months except for US Commodity Corporation Credits (CCC) and Canadian government guaranteed credits which carry three-year terms. Most import financing for the USSR involves medium-term and long-term credits.

Western Credit Available to Eastern Europe Figure 1



Suppliers' Credits

42. Suppliers' credits take two principal forms: documentary or "clean" letter of credit financing, and "indirect" non-recourse financing. Drawings on suppliers' credits account for the largest part of Eastern Europe's outstanding indebtedness.

Documentary Letters of Credit

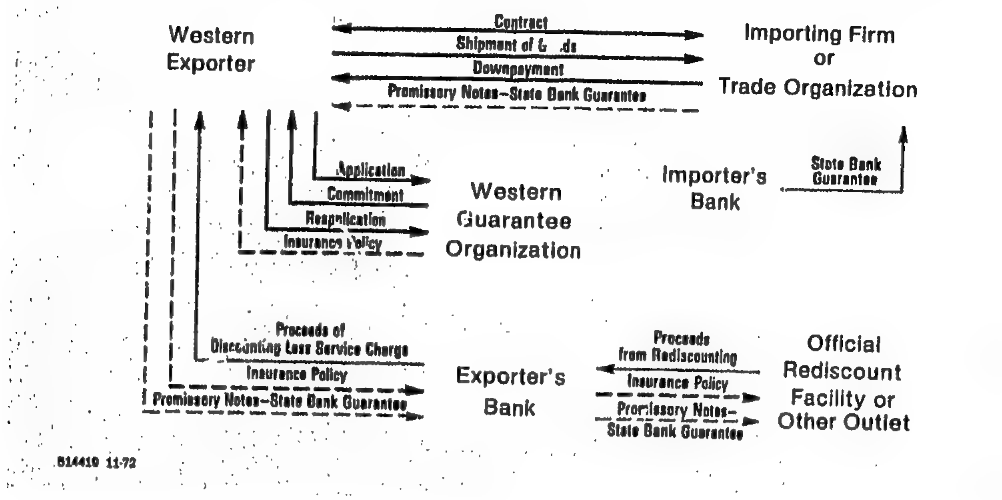
43. Under the terms of these credits, Western banks will open letters of credit at the request of East European banks in favor of exporters to cover shipments to Eastern Europe. The terms of a short-term letter of credit will usually specify that bills of exchange are to be drawn by the exporter against the East European importer. These bills generally must be guaranteed by the importer's bank and accompanied by the appropriate trade documentation -- bills of lading, insurance forms, invoices, and so on -- at such time as they are presented to the exporter's bank for discounting after shipment of the goods. Once bills are discounted by a bank, the exporter has his money and he is finished with the transaction. The bank, however, still has options (see Figure 2). It can either hold the bills until they mature, at which time it can demand payment from the importer, or it can stamp the bills "accepted" whereupon it accepts full responsibility for ultimate payment of the bills at maturity, and the bills become bank acceptances that can be rediscounted on the acceptance market. In some cases, banks can also rediscount short-term guaranteed bills with state-operated refinancing institutions, provided that the terms of the contract and the type of goods involved conform to the standards set forth by the guarantee system. Under clean letters of credit, Western banks do not require that trade documents, which serve as collateral, accompany bills when presented for discounting.

44. Whether or not East European bills of exchange are rediscounted by Western banks depends upon the issuing banks' practices. The Moscow Narodny Bank -- one of the most active in the acceptance market -- discounts East European bills for British and other Western exporters under lines of credit established with each of the six East European banks. MNB then rediscounts (sells) a portion of the bills as acceptances in the London acceptance market. MNB also is active in buying (also called rediscounting) bills from other Western banks. MNB's turnover in this business amounts to several hundred million dollars annually.

45. In the case of some of the large West German commercial banks, bills discounted for exporters, again under lines of credit extended to East European banks, are frequently not rediscounted in West German financial markets. The banks hold the paper until maturity and collect payment from

Figure 2

Medium-Term and Long-Term Suppliers' Guaranteed Financing



East European banks. Banks elsewhere in Western Europe may hold some paper until maturity, but also sell paper in the market when possible.

46. Medium-term and long-term letter-of-credit financing requires promissory notes and periodic payment or amortization. Whereas bills in short-term transactions are drawn by exporters against East European importers, promissory notes are issued by East European importers. Each note is guaranteed by the official East European guarantor bank – each guarantee being numbered serially. Separate notes are issued for each payment (usually semiannual) required under the terms of a credit, with interest at a specified rate usually included in the face amount of each note. Thus each note becomes a separate negotiable instrument which can be discounted and rediscounted in European money markets or, in the case of insured notes, within an official refinancing system.

47. At present, a large share of outstanding East European medium-term and long-term promissory notes have been guaranteed under the various West European insurance schemes. The amount of insured medium-term and long-term credits available to a particular East European country is specified by the credit insurance organizations. Country limits, which indicate the maximum value of guarantees that can be approved, have been established for each East European country. When the limit is reached, as has frequently been the case for Bulgaria and Romania, credit insurance is no longer available, and import financing becomes more expensive and more difficult to arrange.

Indirect Non-Recourse Financing

48. When export insurance is not available to cover East European promissory notes, official rediscounting organizations cannot accept these notes, commercial banks are reluctant to do so, and Western exporters must look to other sources of hard currency in financial markets that are willing to discount such paper. When in need of such credit, Western exporters appeal to their commercial banks to tap the major suppliers of non-recourse funds. This form of credit, known as indirect non-recourse financing, is so named because, in contrast to letter-of-credit financing, the credit is provided in a circuitous fashion with no direct link between the discounting institution and the East European buyer (see Figure 3). Until the mid-1960s, the only significant outlets for non-guaranteed notes were the Soviet banks. These banks were willing to buy up limited amounts of medium-term paper at premium discount rates.

49. Beginning in the mid-1960s, when East European imports of capital equipment began to grow rapidly, the demand for Western non-recourse financing increased, and the specialist banks began to appear, enlarging the market and increasing outlets for East European notes. The growth of this market enabled some of the East European countries, especially Romania and Bulgaria, to import more capital equipment in a shorter time period, while going deeper into debt at a higher cost.

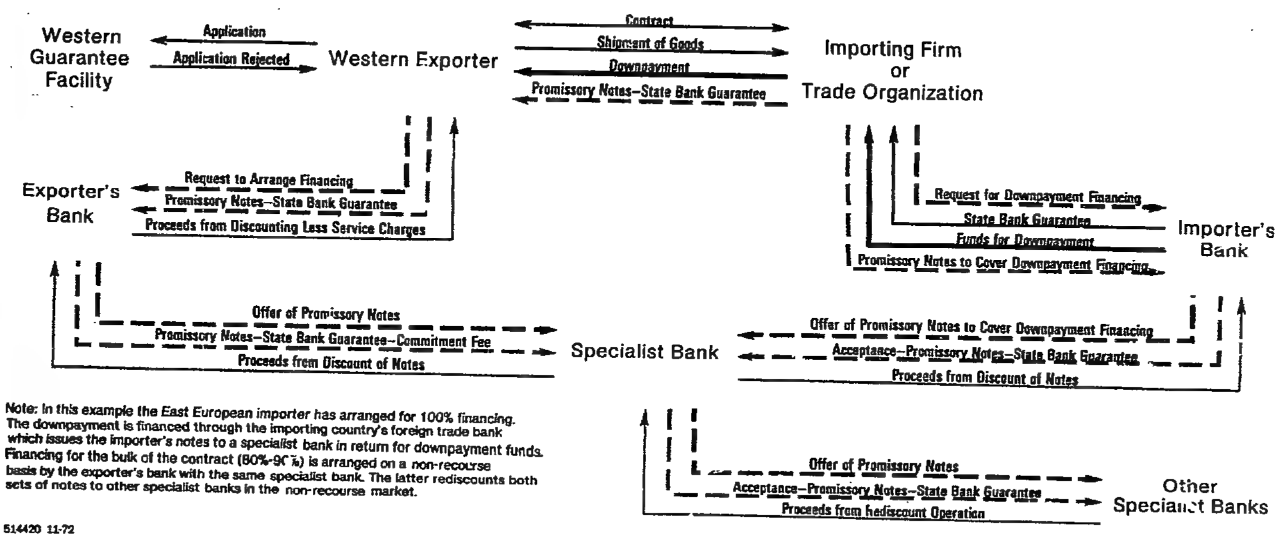
50. Eastern Europe currently owes at least $300 million to $400 million in outstanding non-guaranteed medium-term and long-term paper. As with the market for guaranteed notes, the non-recourse market has its lending limits. The specialist banks are quick to shut off the credit flow if they sense that an East European country is becoming overextended. Rising discount rates quoted for a country's notes signal weakening confidence in that country's hard currency position. The discount rates range from 6% upward to about 13%, depending on contract rates. Steeper rates have been applied to both Bulgarian and Romanian paper, as both countries are frequently in hard currency payments difficulties. The lower rates apply to countries with high credit ratings – Poland, Czechoslovakia, and East Germany. Hungary has not found it necessary to finance imports in this fashion.

Buyers' and Financial Credits

51. Buyers' and financial credits are a somewhat less important, but growing, form of financing available to Eastern Europe. Buyers' credits take the form of indirect financing granted to specific importers. Financial credits are clean deposit credits, extended to banks from single sources as well as consortiums, and tied lines of credit.

Medium-Term and Long-Term Suppliers' and Buyers' Non-Guaranteed Financing

Figure 3



Note: In this example the East European importer has arranged for 100% financing. The downpayment is financed through the importing country's foreign trade bank which issues the importer's notes to a specialist bank in return for downpayment funds. Financing for the bulk of the contract (80%-90%) is arranged on a non-recourse basis by the exporter's bank with the same specialist bank. The latter rediscounts both sets of notes to other specialist banks in the non-recourse market.

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Clean Deposit Financial Credits

52. All major European banks solicit deposits from banks and other sources as a means of building up business and maintaining good relations with correspondents. For East European banks operating in soft currency economies, there are no domestic hard currency deposit funds. East European banks solicit funds by offering interest earnings competitive with prevailing Eurocurrency rates, for terms ranging from a few days up to six months or even longer. Eastern Europe's best sources of hard currency deposits are, as might be expected, the Soviet banks in the West. Eurobank, MNB, and Wozchod Handelsbank, in that order, provide most of these hard currency deposits, usually on a short-term basis, but occasionally for periods of up to two years. At the same time, roughly one-half of the deposits of the Soviet-owned banks originate from non-Communist countries.

53. Clean deposits are the cheapest form of hard currency credit Eastern Europe can get. Even though such deposits are at market rates, they have the added advantage of flexibility over documentary credits. Such credit can be put to almost any use, provided that the funds for repayment, including interest, are available at the end of the deposit period in the appropriate currency -- not always an easy task for banks operating on a hard currency shoestring.

54. Until the late 1960s, East European banks were net creditors in the Eurodollar market, but in the last few years they have begun to enter the Eurodollar market as short-term debtors on a rather large scale. At the end of 1971, they ran a deficit of roughly $600 million, compared with only about $60 million at the end of 1969. It is possible that Hungary, one of the East European pioneers in Eurodollar speculation, has amassed a large short-term deposit deficit in Eurodollars or other Eurocurrencies to cover its unprecedented trade deficit with the West in 1971. The USSR seems to have remained a net creditor in the Eurodollar market.

55. The other form of clean deposit credit is the so-called Eurodollar loan. Eurodollar loans are clean deposit financial credits extended to East European banks by groups or consortiums of Western commercial banks. These credits are typically extended for four to five years at interest rates ranging from 0.75% to just less than 2% over the rate earned on six-month Eurodollar deposits. Eurodollar loans are not connected with any of the federal credit systems, nor are they guaranteed under those systems. The creditors are large Western commercial banks, generally in Europe, although occasionally US and Japanese banks also participate.

56. Eurodollar loans are not tied to the purchase of specific goods, although an East European bank may solicit such a loan, specifying that

the proceeds will be put to a certain use. Hungary has raised $120 million (excluding Eurobond issues) in medium-term credit on the Eurodollar market, including loans of $15 million and $30 million that were supposedly earmarked for development of the aluminum and pharmaceuticals industries, respectively. Shortly after the $30 million credit was extended, Hungary announced that the proceeds of the loan were needed for other purposes, doubtless to take care of repayments falling due. When asked about the apparent misrepresentation by the Hungarian National Bank, one of the bankers heading the consortium stated that it did not matter to the creditors which $30 million Hungary spent on developing pharmaceuticals so long as an equivalent amount of hard currency was used for that purpose within a reasonable period of time. The apparent ease with which funds are raised and the relaxed attitude on the part of creditors have been characteristic of the East European experience with this market. The East European countries have obtained about $500 million in medium-term credit on the Eurodollar market since the late 1960s.

57. An East European country planning to raise Eurodollars through a consortium will usually enlist the aid of a "jobber" (frequently one of the Soviet banks in the West) to feel out the market. He determines availability and cost of funds as well as the appropriate number of lenders ("factors") to participate in a particular transaction. A decision is usually made to determine whether and/or when to publicize the transaction. Some East European banks prefer to borrow Eurodollars on a confidential basis, especially when they are using the loan to repay earlier loans. Other banks in certain circumstances wish the publicity associated with a loan held up until all of the details are worked out and the transaction is completed. When the news is not closely held, by error or design, the Western media are always quick to pick up word of an impending Eurodollar loan to Eastern Europe. Considerable publicity has been attached to Hungary's Eurodollar borrowing as well as to recent loans extended to CEMA's International Bank for Economic Cooperation, which has borrowed $140 million to be repaid over a five-year period from three different West European banking consortiums. However, all of the East European countries, with the possible exception of Czechoslovakia, have borrowed Eurodollars from Western consortia.

Indirect Buyers' Credits

58. Although most of the indirect financing of East European imports is in the form of non-recourse suppliers' credits, occasionally East European importers can raise hard currency to cover downpayments on sizable contracts or to meet repayments on other obligations by issuing promissory notes to one of the specialist banks in Vienna or Zurich, generally on terms of three to four years at rather high rates of interest. Outstanding obligations

of this type probably do not exceed $30 million to $40 million at any one time, again with Bulgaria and Romania being the biggest customers.

Lines of Tied Financial Credits

59. Tied financial credits are granted for promotional purposes by Western producers, exporters or banks. The credit lines are tied in that the credits can only be drawn down by purchasing certain types of products in the country extending the loan. West European countries frequently extend credit lines of this type to kick off new trade agreements or for other promotional motives. The most recent examples of this type of credit are a $200 million line of credit recently extended by Japanese businesses to the Polish foreign trade bank to be used for purchases of Japanese capital equipment, and a $500 million British credit granted to the USSR to promote UK exports of equipment.

Other Forms of Financing

Government-to-Government Loans

60. Western governments occasionally lend money to East European governments for purposes of debt rescheduling, to promote exports, and for various other economic and political reasons. West Germany has been most active in extending credit for refinancing outstanding debts, notably in lending about $100 million to Romania in 1969 and 1970 to cover debt rescheduling. The Chinese government extended a $40 million clean deposit credit to Romania in the fall of 1971 as a part of a trade and cooperation agreement.

61. The United States extended $538 million under PL-480 credits to cover shipments of agricultural products to Poland in 1957-64. The United States also has extended Mutual Security Act loans to Poland amounting to $61 million. US Commodity Credit Corporation (CCC) loans in 1963-71 to Poland, Romania, and Hungary amount to roughly $250 million, and a $500 million line of credit was opened for the USSR in 1972.

62. The Soviet Union has extended a considerable number of so-called emergency hard currency loans to Eastern Europe, the most recent of which was a $100 million loan to Poland to cover meat purchases in the West in 1971-72. As stated above, the Soviets have used their banks in London and Paris to advance these "special" hard currency loans to Eastern Europe.

63. The terms of repayment of government-to-government loans are typically softer than with standard commercial credit. West German

refinancing of credits to Romania allows for grace periods, ballooning payments, and reduced interest rates. Most drawings on US PL-480 credits are being repaid by Poland in Polish zlotys, which have been used by the United States to finance cultural, scientific, and medical projects in Poland. US CCC credits covering exports of agricultural products allow for repayments over three years, whereas such goods are generally financed on terms of one year or less if purchased from private sources. Soviet hard currency credits to Eastern Europe in past years often have either been written off or perhaps repaid in goods at low interest. More recently, however, the Soviets have supplied hard currency to Eastern Europe merely by making credit lines available at the Soviet banks in the West over fairly short time periods and at commercial interest rates.

Eurobonds

64. In June 1971, Hungary became the first East European country to raise hard currency through a bond issue – $25 million worth with maturities of 10 years. The float was carefully orchestrated by MNB. Subscribers were lined up in advance so that when the issue hit the market it was oversubscribed at once. The bonds carry interest of 8.75% and were sold at 99% of par value. Hungary is currently floating bonds worth an additional $50 million on the Eurodollar market. The demonstration effect of these bond floats in terms of the borrowing potential for all of the CEMA countries is at least as important as the $75 million proceeds are to Hungary, which has already raised about $150 million on the Eurodollar market in medium-term loans. There has been speculation in financial circles that CEMA's International Investment Bank will shortly enter the Eurobond market to raise funds for CEMA joint investment projects.

US Lending to Eastern Europe

65. Since the late 1950s, when the United States began shipments of agricultural commodities to Poland financed by PL-480 credits, the United States has extended about $1 billion in medium-term and long-term credits to Eastern Europe. Approximately $750 million to $800 million has been granted to Poland, with most of the rest going to Romania and Hungary. Nearly $800 million has been used to finance deliveries of agricultural products, and roughly $150 million to $200 million in non-guaranteed credits have been extended covering exports of machinery, manufactures, and licenses. Until this year, US lending to the USSR has been small.

66. US affiliate and subsidiary banks in Western Europe have for many years participated in financing West European exports to Eastern Europe. More recently, US subsidiary banks have become fairly heavily involved

in non-recourse financing. The Vienna subsidiaries of the Bank of America, Continental Illinois Trust, the Chemical Bank, the Chase Manhattan Bank, and a few others are particularly active in this money market. Chase Manhattan has recently established a subsidiary finance company (specialist bank) in Vienna. (The Dow Bank's interest in Noreco Finance of Zurich was discussed above.)

67. So long as an East European bank maintains good correspondent relations with US commercial banks and is willing to place short-term deposits with them, the US banks will finance a limited amount of exports to Eastern Europe on medium-term credit without Export-Import Bank guarantees. Of the four countries denied Export-Import Bank credit and insurance (Romania, Poland, and the USSR are currently the only CEMA countries with access to Export-Import Bank coverage), Czechoslovakia and Hungary have the best access to medium-term credit from US commercial banks. East Germany has kept dealings with US banks to a minimum, and Bulgarian utilization, mostly short-term, is at its limit. Bulgaria's indebtedness problems are well known among US banks dealing in East-West trade. On the other hand, the relatively poor credit rating justifiably given debt-laden Romania by the Export-Import Bank has not deterred US commercial banks from undertaking commitments to provide partially insured medium-term and long-term credits to that country.

68. Currently, total short-term and medium-term East European drawings on US credits probably amount to less than $100 million. However, even without Export-Import Bank guarantees, in order to finance US exports of plant and equipment, US banks would probably be willing to permit outstanding medium-term and long-term extensions (excluding CCC credits) to Eastern Europe to reach a level of perhaps $500 million, of which Polish banks could possibly draw as much as $300 million, Romania at least $100 million under Export-Import Bank cover, and other countries perhaps $100 million. If Export-Import Bank insurance and credit become available to cover exports to countries other than Romania, credit would be related less to hard currency supply limitations and would become more a function of trade levels and Eastern Europe's ability to pay.

Prospects

69. The indebtedness of the East European countries in the industrial West will almost certainly continue to rise in the 1970s. They clearly intend to expand purchases of machinery and equipment on credit and will doubtless buy some other commodities on medium-term credit. But most of them are at or near the level of indebtedness at which repayments could become a burden, and they are also looking for ways to acquire Western investment goods and know-how through joint ventures, preferably deals

that encompass the full range of research, production, and marketing of manufactures. Whereas the Soviet Union can bargain for foreign capital in exchange for the exploitation of rich reserves of raw materials, the East European comparative advantage in joint ventures lies in manufacturing and the exploitation of low labor costs.

70. Joint ventures probably are not the answer to the East European demand for increased access to Western know-how and markets, although such ventures have greatly increased in numbers in recent years. But Western exports to Eastern Europe probably will be tied increasingly to Western cooperation in facilitating East European exports. Thus the competition among Western countries for Eastern Europe's trade probably will undergo another shift – from improving credit financing to making concessions on quotas and tariffs, extending help in marketing, and concluding tie-in arrangements, particularly deals that involve partial payment in kind. Promoting imports from, not merely exports to, Eastern Europe is likely to figure increasingly as a condition of maintaining or increasing a share in the East European market.

71. Growing East European insistence on tie-in deals, together with a prospective slowdown in East European exports to the industrial West, suggests that the absolute level of indebtedness in the West will rise less in the 1970s than in the 1960s. The rate of increase will surely be lower. Even so, the total medium-term and long-term indebtedness is likely to amount to considerably more than $5 billion by the mid-1970s (in terms of current US dollars). How large a share of this expanding debt the United States will finance depends finally on the US business community. If business interest is strong enough, Export-Import Bank coverage and the necessary legislation for most-favored-nation status will probably come soon, and US firms will learn to sell in Eastern Europe and to help Eastern Europe sell in the United States.

72. On the basis of the volume of new orders for Western capital goods in the past year and the CCC credits made available, Soviet indebtedness will continue to increase in the future – probably at an accelerated rate. The USSR has sought to lighten the burden of its growing debt by concluding "self-liquidating" credits – that is, credits to be repaid with the products of the installation built with these credits (for example, gas for pipe and wood products for wood processing equipment). The multi-billion dollar liquefied natural gas project being discussed between the United States and the USSR would involve this sort of arrangement.

73. The United States is expected to play a major, if not a dominant, role in Soviet financing of its imports from the West in the future. In addition to the CCC line of credit, the Export-Import Bank and Soviet

officials currently are negotiating long-term credits worth some $200 million in support of US exports for the Kama truck plant and a plant to manufacture tableware. Moreover, the Bank of America has announced that it would lead a 13-bank consortium in financing $68 million worth of tractors to the USSR over seven years (apparently without Export-Import Bank participation), and the First National City Bank of New York and the Chase Manhattan Bank have revealed that they had applied for permission to open facilities in Moscow. [redacted] 25X1

APPENDIX

Glossary of Technical Terms

Bank acceptance: A time or term bill of exchange discounted by a commercial bank. A bank will usually stamp "accepted" across the face of the bill. The element which gives value to the bill is the credit standing and reputation of the bank which accepted it. Once accepted by a first-class bank, a bill can be rediscounted in the acceptance market, allowing the bank to replenish its funds for additional business. In the case of East European bills, the terms of acceptance credits sometimes require that the drawee (importer) must also accept the bills before they can be discounted as acceptances. This type of bill is called "two-name paper," a self-explanatory term.

Bill of exchange: A negotiable draft drawn by an exporter on an importer at sight or over a specified credit period to cover the contract price of goods in a trade transaction. In East-West trade, bills of exchange are associated with short-term transactions and are generally drawn under a letter of credit opened in the exporter's favor.

Buyers' credits: Credits granted directly to foreign buyers by banks or other credit institutions, enabling them to pay cash to suppliers for imports.

Clean credits: Time or sight deposits and letters of credit in which no documents of title are called for and which do not involve goods.

Discounting: The term used to refer to the commercial bank practice of buying bills of exchange and promissory notes from exports by paying the present value of the debt which it will collect at a future time.

Documentary credits: Financing, usually by letter of credit, requiring that the trade documents (invoice, bills of lading, insurance certificate, and others) accompany bills of exchange when discounted at a commercial bank.

Eurodollars: A dollar deposit, usually on a term basis, made with a foreign bank outside the United States.

Factor: A supplier of funds, generally in Eurodollar or non-recourse financing.

Financial credit: As used in this memorandum, financial credit refers to credits granted by Western banks or other sources to East European banks. Distinguished from buyers' credits, which are granted to specific importers.

Guaranteed credits: Credits insured under export insurance programs of government and government-supported agencies in the West and by the Soviet-owned Garant insurance company.

Jobber: A financial institution, generally a commercial bank, prominent in Eurodollar dealings, and specializing in placing funds as an intermediary. The Bank of London and South America, Ltd., is considered as one of the major Eurodollar jobbers, and it has arranged a few East European loans. Nonetheless, the Soviet banks in the West are virtually in a monopoly position as Eurodollar jobbers where the CEMA countries are concerned, having a part at some stage in every consortium loan going to Eastern Europe.

Letter of credit: A bank-to-bank credit facility extended by an exporter's bank at the request of an importer's bank whereby the former agrees to accept, for discounting, bills of exchange or promissory notes drawn in favor of the exporter against the importer.

Non-guaranteed credits: Credits not insured under export credit guarantee systems. Mainly non-recourse credits, Eurodollar loans, and a portion of short-term and medium-term documentary credit.

Non-recourse credits: Supplier's financing whereby the bank accepting bills or notes for discount absorbs the risks of advancing funds to an exporter and of collecting payment from the importer. The bank waives its right of recourse to the exporter.

Promissory note: A negotiable instrument issued by an importer containing his promise to pay the bearer at maturity the amount specified on the face of the note. Promissory notes are issued to cover periodic payments required for medium-term and long-term credit periods.

Rediscounting: The sale, usually by a bank, of exporter's bills and importer's promissory notes to another bank, an official rediscounting institution, or any other source of refinancing, for the purpose of replenishing funds and increasing liquidity.

Suppliers' credits: Credits granted by suppliers, usually through commercial banks, to foreign buyers. In East European trade, letter of credit financing and indirect non-recourse credits are the principal forms of Western suppliers' credits.

Tied credits: Buyers' financing linked to the purchase of specific goods or types of goods.